

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]:TL-N-6228-97
[REDACTED]

date: MAR -9 1999

to: Chief, Examination Division, [REDACTED]
[REDACTED], Team Coordinator - [REDACTED]
Keith Pluto, Revenue Agent - [REDACTED]

from: Associate District Counsel, [REDACTED]
[REDACTED]

subject: [REDACTED]

Deductibility of Legal Fees Incurred as a result of the
[REDACTED]
U.I.L. No. 162.05-21

This responds to your request for advice regarding whether [REDACTED] properly deducted certain legal fees paid during [REDACTED] and [REDACTED] in connection with the [REDACTED]. Our advice is provided without prior coordination with the Office of Chief Counsel, pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as this issue involves primarily well-settled principles of law. We are required, however, to forward a copy of this memorandum to both the Assistant Chief Counsel (Field Service) and the Northeast Regional Office for review. Within 10 days after receipt, the Associate Chief Counsel is to advise this office as to whether it: 1) concurs with our opinion; 2) believes some modification is appropriate; or 3) needs additional information or time to evaluate our opinion. We will inform you of their response as soon as it is received.

Disclosure Statement

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document is also tax information of the instant taxpayer which is subject to section 6103 of the Internal Revenue Code¹.

Issue

Whether [REDACTED] has a fixed obligation under the [REDACTED] to reimburse [REDACTED] for legal fees incurred by it in defense of various legal actions brought against [REDACTED] as a result of the [REDACTED] [REDACTED]².

Conclusion

To deny an otherwise allowable expense deduction on the ground that the taxpayer is entitled to reimbursement from a third party, it must be shown that the taxpayer's right of reimbursement was fixed, without substantial contingencies. The amount of the reimbursement must also be fixed. We do not believe that [REDACTED]'s rights against [REDACTED] as a result of the [REDACTED] [REDACTED] have matured to such level. We believe that as of the close of the tax years in issue, [REDACTED] had a right under the [REDACTED] to pursue reimbursement from [REDACTED]. Although no formal claim for recovery has yet been submitted, [REDACTED] has indicated that it would contest any such claim and might likewise pursue claims against the other owners of [REDACTED]. Clearly the [REDACTED] [REDACTED] demonstrated a willingness on the part of [REDACTED] to defend against claims for recovery. We believe that there is far too much uncertainty surrounding [REDACTED]'s right to or the amount of reimbursement to deny the deductions at issue on the basis proposed.

As discussed below, it appears that [REDACTED] sought to recover the cost of the legal fees at issue through increased tariffs that it charged shippers of [REDACTED] who used the [REDACTED] to transport their production. [REDACTED] was subsequently ordered to refund these increased tariffs to the

¹ All section references hereinafter, unless otherwise indicated, are to the Internal Revenue Code as in effect during the years in issue.

² The [REDACTED] provides that a party subject thereto shall be strictly liable to the [REDACTED] for damages resulting pollution discharges, e.g., [REDACTED], made by such party. [REDACTED]

[REDACTED]. Although it may not be legally inaccurate, we have (for purposes of simplicity) assumed that any right of reimbursement which may be owed to [REDACTED], is likewise owed to [REDACTED].

shippers in [REDACTED]. While we believe that it is likely that [REDACTED] properly reflected the increased tariffs as income and deducted the [REDACTED] refunds, we nonetheless recommend that you confirm this during the course of the [REDACTED]-[REDACTED] audit cycle.

Facts

Overview The [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Producers of [REDACTED] from [REDACTED] [REDACTED] who use [REDACTED] to transport their production to [REDACTED] must pay a tariff to the [REDACTED] owners. [REDACTED] tariff rates are subject to review and approval by the [REDACTED] in accordance with the [REDACTED]. [REDACTED]

The tariff's charged producer's by the [REDACTED] owner's have a direct effect on [REDACTED] revenues. The state receives royalties and collects taxes from the producers based upon the [REDACTED] price of [REDACTED]. Since [REDACTED] tariffs reduce the [REDACTED] value of the [REDACTED], [REDACTED]'s revenues are decreased by increases in the tariffs charged producer's who ship their production via [REDACTED].

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED].

On [REDACTED], a [REDACTED] administrative law judge issued an order ruling against the movants on their motion for summary judgement. [REDACTED]. A copy of that order is attached hereto as Attachment B. The judge concluded that that:

[REDACTED]

Page [REDACTED] of [REDACTED]

The movants subsequently appealed the judge's order of [REDACTED] to [REDACTED] itself. [REDACTED]. On [REDACTED] the [REDACTED] issued an order reversing an earlier ruling by the administrative law judge on [REDACTED] in which the judge found that the [REDACTED] owners were entitled to recover the [REDACTED] settlement and legal fees by way of tariff increases, under the [REDACTED] and the [REDACTED] ("[REDACTED]"). [REDACTED]. [REDACTED], however, deferred ruling on the appeal of the judge's [REDACTED] ruling on the movants' motion for partial summary judgement, pending the outcome of a supplemental issue which likewise arose under the [REDACTED] and the [REDACTED] ("[REDACTED]"). On [REDACTED] [REDACTED] issued its order on [REDACTED], holding that the [REDACTED] owners were not entitled to recover the costs and fees at issue by way of increased tariffs. [REDACTED] also found that its ruling on the [REDACTED] rendered the pending appeal of the judge's [REDACTED] order moot, and therefore did not consider that appeal further. [REDACTED]⁴. The [REDACTED] owners thereafter appealed to the U.S. Court of Appeals, seeking to reverse the [REDACTED] orders of [REDACTED] and [REDACTED].

⁴ On [REDACTED] the Commission issued an order directing the [REDACTED] owners to make appropriate refunds in accordance with its order of [REDACTED]. [REDACTED]. The [REDACTED] owners thereafter made refunds for the years [REDACTED] and [REDACTED], and filed refund reports. In addition, the Commission directed the [REDACTED] owners to refund the entire amount of the [REDACTED]-related legal expense and settlement costs recovered in their [REDACTED] rates. [REDACTED].

relating to [REDACTED]. [REDACTED]. The Court of Appeals ruled against the [REDACTED] owners and upheld [REDACTED] on [REDACTED]. Consequently, the appeal of the [REDACTED] order remains unaddressed.

Proposed Adjustment The examining revenue agent has proposed adjustments disallowing [REDACTED]'s deduction for the legal fees that it paid in connection with the [REDACTED] litigation during tax years [REDACTED], [REDACTED], and [REDACTED]⁵. The agent contends that [REDACTED] and the other [REDACTED] owners are entitled under the [REDACTED] to be reimbursed from [REDACTED] for these expenses. The agent has cited various case law authorities establishing the rule that a taxpayer cannot claim a deduction for an expense which is reimbursable by a third party.

[REDACTED] and its owners (which includes [REDACTED] and [REDACTED] are subject to the [REDACTED]. It states that its terms and conditions are enforceable as contractual obligations." [REDACTED] at [REDACTED]. Among its provisions are the rights and duties between the parties arising from the [REDACTED] by a [REDACTED] owner's [REDACTED]. See Attachment A. In particular the [REDACTED] provides:

[REDACTED]

[REDACTED]

[REDACTED]

⁵ The agent proposed to disallow deductions totaling \$[REDACTED], \$[REDACTED] and \$[REDACTED] for tax years [REDACTED], [REDACTED], and [REDACTED] respectively. [REDACTED] indicates that its deductions for [REDACTED]-related legal expenses were actually \$[REDACTED], \$[REDACTED], and \$[REDACTED] for tax years [REDACTED], [REDACTED], and [REDACTED] respectively. [REDACTED] contends that the excess of the proposed disallowance over the alleged legal fees represents deductions taken by [REDACTED] for its share of [REDACTED] response team costs.

[REDACTED] at pp. [REDACTED] - [REDACTED]

The [REDACTED] provides that [REDACTED] is to submit a claim to the [REDACTED] after it has determined its resulting damages, and the [REDACTED] shall make payment to [REDACTED] on the claim within 60 days of receipt. A [REDACTED] who fails to pay within the 60 days will be refused [REDACTED], until full payment is made or arbitration is initiated and a bond is posted. The [REDACTED] provides that binding arbitration shall be the sole remedy to resolve disputes as to the respective liabilities arising out of a pollution discharge. [REDACTED] at p. [REDACTED].

Exam argues that under the terms of the [REDACTED] set forth above, [REDACTED] as the [REDACTED], is strictly liable to [REDACTED] (and thus to [REDACTED] and its other co-owners) for the costs it incurred as a result of the [REDACTED]. [REDACTED] disagrees, however, relying upon many of the same decisional authorities cited by the agent. [REDACTED] contends that these same authorities establish the rule that in order to disallow a deduction because it is "reimbursable", it must be shown that the taxpayer had a fixed right of reimbursement from a third party as of the close of the year at issue. [REDACTED] contends that it had no fixed right to reimbursement under the [REDACTED], as the [REDACTED] allows [REDACTED] to contest or challenge a claim for reimbursement submitted by [REDACTED]. [REDACTED] alleges that [REDACTED] sought reimbursement from [REDACTED] for the legal fees at issue, which [REDACTED] denied. [REDACTED] was unable to provide a copy of any document or evidence showing that [REDACTED] in fact submitted a claim seeking reimbursement from [REDACTED]. A copy of [REDACTED]'s statement of position regarding the proposed adjustments and supporting exhibits are included herewith as Attachment C.

Analysis

As a general rule, a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162. However, if the expenditures are made under an agreement which provides that the taxpayer will be reimbursed therefor, then such expenditures are considered to be in the nature of loans or advances to another or of payment on behalf of another and are not deductible as business expenses of the taxpayer making the payment.

Glendinning, McLeish & Co. v. Commissioner, 24 B. T. A. 518, 523 (1931), affd. 61 F. 2d 950 (2nd. Cir. 1932). The right to reimbursement, however, must be fixed. A right to reimbursement is sufficiently fixed so as to deny the related expense deduction when such right has matured without further substantial contingency. The fact that actual payment must await the performance of certain ministerial or mechanical acts on the part of a third person or governmental agency does not render the payment contingent. Charles Baolian Company v. Commissioner, 68 T.C. 620 (1977). An otherwise proper deduction should not be disallowed in the year in which it is paid or incurred because of the existence of a possibility that at some future date the taxpayer might receive a reimbursement therefor. Allegheny Corporation v. Commissioner, 28 T. C. 298, 305 (1957). Additionally, not only must the right of reimbursement be fixed, but the amount of the reimbursement must be fixed as well, in order to deny an otherwise proper deduction on the ground that it is reimbursable. Fourth Financial Corporation and Consolidated Subsidiaries v. Commissioner, TC Memo. 1985-232.

Under the [REDACTED], an [REDACTED] is strictly liable to the other [REDACTED] co-owners for costs that they incur as a result of the [REDACTED]. Clearly, the [REDACTED] in question was [REDACTED] into [REDACTED] by the [REDACTED] and [REDACTED] as the owner of the [REDACTED], is thus strictly liable under the [REDACTED], for costs incurred by the other [REDACTED] co-owners. [REDACTED] alleges that [REDACTED] sought reimbursement from [REDACTED] but was refused⁶.

Although the [REDACTED]'s imposition of strict liability on the [REDACTED] would suggest an absolute obligation on its part to reimburse the other [REDACTED] co-owners for their costs resulting from the [REDACTED], regardless of fault on their part, such is not

⁶ Although it appears that [REDACTED] in fact discussed reimbursement with [REDACTED], there is no evidence that it actually pursued a formal request for reimbursement, and attempted to exercise its rights under the [REDACTED] upon the refusal of its claim by [REDACTED].

the case. Rather, the [REDACTED] gives the [REDACTED] the right to reduce its liability to [REDACTED] if it can show that a discharge of pollutants was caused by [REDACTED]'s negligence or willful misconduct, to the extent of [REDACTED]'s percentage of fault in causing the discharge. [REDACTED] contends that [REDACTED] responded to [REDACTED]'s request for reimbursement by asserting that it would pursue its rights under this provision against [REDACTED] for its negligence in connection with the [REDACTED]. The fact that [REDACTED] was considering pursuing claims against [REDACTED] is supported by notes to a [REDACTED] SEC filing by [REDACTED], which is included herewith as Attachment D.

We believe that [REDACTED] did not have a fixed right of reimbursement from [REDACTED] under the [REDACTED] as a result of the [REDACTED]. Rather, it appears that the [REDACTED] merely gave [REDACTED] and [REDACTED] a right to pursue recovery from [REDACTED]. The [REDACTED] produced a tremendous volume of litigation, estimated by [REDACTED] to be in excess of [REDACTED] lawsuits. [REDACTED] has clearly indicated a willingness defend these lawsuits. It likewise has expressed a willingness to defend against claims for reimbursement from [REDACTED] as well as possibly seek recovery of damages from [REDACTED] itself. While [REDACTED] and [REDACTED] may not have filed formal claims for reimbursement from [REDACTED] as required under the [REDACTED], we do not consider this to be significant as we believe that [REDACTED]'s threat to sue [REDACTED] was real, given the amount of money at stake, i.e., in excess of \$[REDACTED] legal fees and settlement costs.

Given that it appears likely that the only way for [REDACTED] and [REDACTED] to recover these costs from [REDACTED] would be to submit their claims to arbitration, we believe that neither the right to nor amount of the reimbursement due [REDACTED] under the [REDACTED] was sufficiently fixed to deny the deductions as proposed. For example, in Electric Tachometer Corp. v. Commissioner, 37 T.C. 158 (1937), the issue was whether the taxpayer was entitled to reimbursement from the state of Pennsylvania for moving expenses that it incurred as a result of the state's exercise of its right of eminent domain. The taxpayer received a letter from the Pennsylvania Department of Highways in 1954, informing it that its premises would be appropriated for highway construction purposes. The letter further stated, among other things, that the taxpayer would be supplied with forms for use in submitting any claim which it had for damages, and that upon receipt of such claim it would be examined on its merits and an endeavor made to arrive at an amicable settlement. A claim number was set forth at the top of the letter, and petitioner was requested to use that number in any correspondence about its claim. In 1955, the taxpayer received a formal eviction notice, advising it that demolition would begin in a matter of months, and that the

taxpayer should make arrangements to remove all personal effects from the condemned property prior to demolition. The taxpayer did so, incurring various moving expenses in 1955 and 1956. The taxpayer sought recovery of these expenses from the state, which led to legal proceedings in 1957. After hearings, the taxpayer reached a settlement with the state on the amount of the taxpayer's reimbursement. The taxpayer claimed moving expense deduction for 1955 and 1956, which the Commissioner subsequently disallowed, on the ground that the expenditures were reimbursable. In holding for the taxpayer, the court stated:

The question here is whether there existed such a fixed right in petitioner to reimbursement for its moving expenses that the amounts paid by it were, in fact, in the nature of an advance to or payment on behalf of another. The facts in this case show that petitioner had no such fixed right to reimbursement.

Under these facts, the right to receive reimbursement was not sufficiently fixed to make the expenditure in the nature of an advance or something other than an expense incurred in petitioner's business. The amount of the expense was fixed at the close of the taxable year in which it was paid and the contingency which existed was whether petitioner would be reimbursed for such payment.

Electric Tachometer, 37 T.C. at 162,163.

We believe that Electric Tachometer has application to the facts of this case. The taxpayer in Electric Tachometer merely had a right to pursue recovery from the state of Pennsylvania at the time it incurred the moving expenses. The state did not accept the taxpayer's claims for reimbursement, forcing the taxpayer into litigation. [REDACTED] and [REDACTED] likewise have a right under the [REDACTED] to pursue recovery from [REDACTED]. [REDACTED] has indicated that it will deny these claims. Clearly [REDACTED]'s right of reimbursement was not sufficiently mature, i.e., further substantial contingencies existed, at the close of [REDACTED], to preclude it from qualifying as fixed right of reimbursement.

We believe the order of the [REDACTED] administrative law judge denying the movants' motion for partial summary judgement is based upon similar concerns (as well as others which we are unable to address at this time), and thus lends support for our conclusion. We are mindful of the fact that [REDACTED] and the other [REDACTED] owners were able, if only temporarily, to recover the legal fees at issue by way of increased tariffs charged the [REDACTED]

shippers. We also recognize this likely dulled their enthusiasm for pursuing their rights under the [REDACTED] against [REDACTED].

We believe that it is likely that [REDACTED] reflected the additional revenues generated by the increased tariffs charged the [REDACTED] [REDACTED] to recover the expenses at issue were in fact reflected in its taxable income for the years in issue as well as [REDACTED], [REDACTED] and [REDACTED]. We likewise believe that it is likely that [REDACTED] claimed a deduction in [REDACTED] as a result of the refunds thereof that it paid to the affected [REDACTED] [REDACTED]. Nonetheless, we recommend that you confirm this to be the case in during the [REDACTED]-[REDACTED] audit cycle. An adjustment would appear to be warranted if, for example, [REDACTED] failed to recognize the increased tariff revenues received during the [REDACTED]-[REDACTED] tax years, but then deducted the refunds that it paid the [REDACTED] [REDACTED] in [REDACTED].

If you have any questions regarding the foregoing, please contact Chris Fisher at (216) 522-3380.

RICHARD E. TROGOLO
District Counsel

By: (SIGNED) CHRISTOPHER A. FISHER
CHRISTOPHER A. FISHER
Senior Attorney

Attachments:

- Attachment A - Pollution Discharges, pp. [REDACTED]-[REDACTED] of the [REDACTED]
[REDACTED]
- Attachment B - [REDACTED]
- Attachment C - [REDACTED] statement of position in opposition to proposed adjustments, with attachments
- Attachment D - SEC Form [REDACTED], pp. [REDACTED] and [REDACTED], filed by [REDACTED]
[REDACTED] for [REDACTED]